

Regulatory Bulletin

Handbook: Thrift Activities
Subject: Nondeposit Investment Sales

Section: 640
RB 32-4

April 25, 1996

Nondeposit Investment Sales

Summary: This bulletin revises and updates the OTS examination guidelines regarding sales of nondeposit investment products and provides for the distribution of revised Thrift Activities Handbook Section 640, newly entitled Nondeposit Investment Sales.

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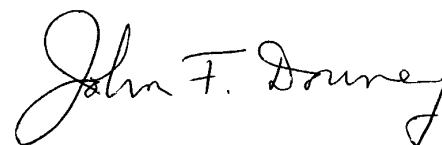
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Attached is the new Thrift Activities Handbook Section 640, which replaces the existing section, Securi-

ties Brokerage, in your Thrift Activities Handbook. The section is now entitled Nondeposit Investment Sales to more accurately reflect the scope of the activity. Certain corrections are shown and, in addition, new procedures for examination of proprietary funds were added. A new appendix C is added, Questions and Answers about Nondeposit Investment Products, to aid

examiners and savings associations by answering frequently asked questions. Changes are shown in **bolded italics**.

Attachment



—John F. Downey
Executive Director, Supervision

CHAPTER: Related Organizations

SECTION: Nondeposit Investment Sales

Section 640

Introduction

The risk-focused approach to examining related organizations, as detailed in Handbook Section 610, Overview, allows flexibility in setting the examination scope. The scope must be reasonable and prudent, yet sufficient to evaluate the extent to which a subsidiary poses a risk to the parent thrift. This Section focuses on specific regulatory restrictions, policy standards and safety and soundness concerns associated with securities brokerage activities.

A securities brokerage subsidiary can be an important element of a parent thrift's overall business strategy. It can provide a parent thrift with the potential to increase consolidated earnings, retain customers (certificate of deposit (CD) holders seeking higher returns and investment alternatives), cross-sell its services to provide a full range of financial products, and diversify its investments.

Thus far, thrifts are not directly involved in securities brokerage activities although there is no statutory prohibition against direct sales. Thrifts, unlike banks, are not exempt from the definitions of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934. Thrifts would, therefore, be required to register as a broker-dealer to sell nondeposit investment products directly. In the event that a thrift did register as a broker-dealer and received OTS approval to offer such products, the guidelines contained herein would be useful in determining whether the thrift maintains appropriate safeguards. This section ***applies to the sale of stocks, mutual funds, and variable rate and fixed rate annuities.*** This section, however, does not apply to sales of nondeposit investment products to nonretail customers, such as sales to institutional customers and fiduciary accounts administered by the thrift. ***In addition, this section does not apply to pure insurance products such as credit life insurance.***

Retail sales, on thrifts' premises, of nondeposit investment products (or "investment products") have become increasingly prevalent. Thrifts have traditionally conducted such activities through a service corporation subsidiary. In many cases, the subsidiary offers securities brokerage services in the thrift's offices ("on-premises") where deposit taking and other thrift functions are performed. Thrifts usually engage in securities brokerage activities on an "accommodation basis" such as providing customers

with access to promotional materials, telephones for placing orders with a broker and limited banking services related to the service corporation's brokerage function, however, they may also directly lease space to a brokerage dealership under certain conditions.

Two primary areas of concern regarding on-premises sales of investment products is the thrift's overall exposure to loss and whether customers fully understand the characteristics and risks associated with such products. Thrift and service corporation management and boards of directors should establish prudent internal controls, such as those described in this Section, to ensure that securities brokerage activities comply with sound business principles as well as applicable regulatory requirements and restrictions. The level of detail contained in internal policies and procedures will depend on the structure and complexity of the brokerage activities.

While the purpose of this Section is to assist regulators when evaluating the effect of a service corporation's securities brokerage program on the parent thrift, the risk assessment issues that are discussed will generally apply to other third party arrangements involving on-premises sales of investment products. You should be aware that some differences do exist. For example, OTS regulations pertaining to service corporations (i.e., activities restrictions and operating standards) do not apply to lease arrangements between a thrift and a third party. Also, customer referral arrangements between service corporations and their parent thrifts are generally not permissible under a thrift/nonsubsubsidiary lessee relationship.

To determine the level of risk associated with a service corporation's brokerage activities, the regulator must obtain an understanding of the securities brokerage program, applicable OTS policy and regulatory standards and the securities brokerage environment. Specifically, this Section discusses the topics summarized below.

The Business of Securities Brokerage

Securities brokerage firms are regulated at the federal and state levels. The OTS does not review these entities to determine whether they comply with securities rules and regulations. The regulator should, however, evaluate the effect on the parent thrift of a brokerage firm's relationship with its service corporation. The oversight of brokerage firms by securities regulators

provides important information in determining the appropriate scope of a service corporation review. The extent to which a service corporation's brokerage program complies with securities laws, rules and regulations can materially affect the entity's viability, the thrift's exposure to loss and the public's overall perception of the parent thrift.

Policy on Sales of Investment Products and Referral Activity

Securities brokerage activities and related customer referral practices that occur on a thrift's premises must be performed in a manner that is consistent with the interagency policy detailed in Thrift Bulletin (TB) 23-2. The bulletin sets forth operating safeguards that management must implement to clearly distinguish insured deposits from uninsured investment products in order to minimize customer confusion and the overall level of risk presented to the thrift. Additionally, OTS regulatory requirements and restrictions that apply to specific aspects of on-premises securities brokerage activities are also discussed (i.e., transactions with affiliates, relationships with service corporation subsidiaries).

Service Corporations' Securities Brokerage Program

Securities brokerage activities conducted through a thrift's service corporation must be limited to those that are preapproved or specifically authorized by the OTS. The brokerage program must comply with OTS regulatory requirements (i.e., maintenance of separate corporate identities, usurpation of corporate opportunity) that generally apply to all service corporations as detailed in Handbook Section 610. Service corporations, unless operating as an independent brokerage operation, generally use third parties to sell, market, or otherwise provide brokerage services to its customers, but these arrangements must be monitored in a prudent manner. The various aspects (i.e., sales practices, disclosures, advertising) of a service corporation's brokerage activities and potential areas of risk, are detailed throughout this Section.

Description of Securities Brokerage

A detailed discussion of the securities brokerage business and its complex regulatory environment is beyond the scope of this Section. However, the following general information is pertinent to the regulator's review.

How Securities are Sold

Securities in the United States are bought and sold in two primary markets: the over-the-counter (OTC) market and stock exchanges. Service corporations engaging in securities brokerage activities deal in the OTC market. This market consists of a nationwide network of "brokers" and "dealers" who buy and sell stocks and bonds to and from each other and to and from customers. While brokers conduct transactions in securities for the accounts of others, dealers engage in the business of buying and selling securities for their own account. The term broker-dealer describes an entity (i.e., corporation or joint venture) that engages in both activities. A "principal" is an officer or partner of a brokerage firm who is responsible for a certain functional area. Sales persons employed by broker-dealers are referred to as "registered representatives" at the federal level and as "agents" by state authorities. Representatives and agents must be licensed in accordance with applicable federal and state laws.

Types of Brokerage Services

Service corporations are often distinguished as providing either "discount" or "full brokerage" services. A discount brokerage operation generally deals only in buying and selling securities. It offers no investment advice and makes no margin loans (loans that permit securities trades on credit with a deposit of a specified portion of the sales price maintained in a customer account). A full-service broker-dealer offers comprehensive services including investment advice and margin loans in addition to a full range of products.

The two major types of brokerage transactions are agency and principal. The most common type of transaction in service corporations is an agency transaction in which the broker-dealer acts on behalf of a customer only and is compensated through commissions. A principal transaction occurs when the broker-dealer trades securities for its own account.

Investment advice offered through a service corporation may be provided on an individual or standardized basis. Individual advisory services generally involve the assessment, by a registered representative, of a customer's financial condition, investment goals and other factors to recommend the appropriate mix of investments for the client. Standardized investment advisory services may entail providing one of several categories of advice to an investor based on a

determination of what is suitable given that person's financial status and goals. Such services might include purchase and sale recommendations derived from an independent advisory service or from the principals of the brokerage firm.

There are a number of different ways in which a service corporation can offer securities brokerage services. These range from a very minimal commitment to the formation of a full-service brokerage dealership. The following types of brokerage programs are the most common.

Referral Marketing

This is an arrangement where the employees of the thrift or its service corporation refer customers to a 1-800 telephone number. The number reaches a broker-dealer that has a contractual agreement with the service corporation. The agreement should stipulate the percentage of the gross commissions that the service corporation is to receive. Service corporation or thrift employee functions are generally limited to handling the transfer of funds between customer accounts and making telephones or promotional material available to prospective brokerage customers.

Turnkey Program

Under this arrangement, the service corporation enters into an agreement to make available customer names, telephones and desk space to a broker-dealer's registered representatives. In return, the broker-dealer provides the service corporation with a percentage of commissions (generally 50%) generated from the brokerage program. This arrangement typically does not involve substantial, if any, upfront fees to be paid by the service corporation. The registered representatives are exclusively employed by the broker-dealer and all customer contact relating to securities sales occurs through the broker-dealer's employees. Thus, the broker-dealer must recruit, screen, train, and manage the sales force.

Joint Venture

This is an arrangement between a broker-dealer and the service corporation that generally involves certain start-up costs and various operating expenses (i.e., office and computer equipment, telephones, promotional materials, and licensing and training

expenses for employees). Registered representatives are usually dual employees of the service corporation or parent thrift and the broker-dealer. A senior officer of the broker-dealer should be responsible for monitoring the registered representatives' compliance with applicable securities laws and regulations. The percentage of commissions retained by the service corporation should be detailed in a written agreement along with other contractual obligations. (Refer to the discussion of "Third Party Arrangements.")

Independent Broker-Dealer

A thrift may establish its service corporation as an independent broker-dealer. This arrangement requires a substantial commitment of managerial and financial resources. The financial commitment requires basic start-up costs and continuing operating expenses such as: legal and securities consultation fees, training, various registration and licensing costs, and computer/software costs. A broker-dealer is responsible for registering itself with the Securities and Exchange Commission (SEC) and appropriate state regulatory bodies. The broker-dealer must, among other requirements, become a member of the National Association of Securities Dealers (NASD) and, as a member, is required to meet minimum capital requirements, submit periodic reports, monitor compliance with laws and regulations governing securities brokerage, and obtain required insurance coverages.

Scope of Regulation

Securities transactions in the United States are regulated at the federal and state levels. Generally, federal regulation governs transactions of an interstate nature. State laws may vary in scope, but apply to activities and products transacted within their borders. Broker-dealers are regulated at the federal level by the SEC. They must be registered with the SEC to engage in business on an interstate basis, and must also comply with any registration requirements of the states and self-regulating organizations (SROs) such as those of the exchanges or the NASD.

While broker-dealers and their employees must adhere to registration or licensing requirements, the products that they sell must also be registered. At the federal level, securities must be registered with the SEC. The SEC has no legal authority to determine whether a security is offered to the public. It can only require that an issuer provide adequate, relevant

information to enable a potential buyer to make an informed decision regarding the purchase. Additionally, state law generally requires that securities be registered or otherwise approved by state authorities.

Since broker-dealers maintain custody of the funds and securities of their clients, the SEC requires that they show evidence of financial responsibility, and establish mechanisms for customers to recover funds should the broker-dealers become insolvent or otherwise unable to meet their responsibilities. There are three principal ways in which this is accomplished:

- Net capital rules. Broker-dealers are required to maintain certain levels of capital. These levels generally depend on the activities in which they engage. Many service corporations structure their program to comply with the SEC's policy on networking arrangements so that the net capital rule is not enforced. This generally occurs when a service corporation is associated with a registered broker-dealer. Arrangements between service corporations and third party broker-dealers are very common.
- Handling of customer funds. Broker-dealers must comply with requirements for segregation of customer funds and securities. Thus, broker-dealers must implement adequate measures for ensuring that client and broker funds and securities are maintained separately.
- Maintenance of industry-wide protective fund. The Securities Investor Protection Corporation (SIPC) is responsible for the oversight of this fund. The purpose of the fund is to satisfy claims of customers if a brokerage firm becomes insolvent. This fund is maintained through assessments of members. The SIPC may borrow funds from the United States Treasury in the event that assessments are insufficient to cover its obligations.

Federal and state laws also include anti-fraud provisions that address manipulation of securities trading markets. These laws apply to, among other things, insider trading based on nonpublic information, as well as actions and statements by management designed to deceive others.

As can be seen, broker-dealers must conduct their business in accordance with extensive, and often complicated, federal and state statutes and regula-

tions. The NASD, SEC and state authorities regularly examine broker-dealers. The OTS regulator can consult with appropriate regulatory authorities and request copies of recent examination reports or other records that may be pertinent to the service corporation review. Violations of securities laws or other concerns of securities regulators should be considered when evaluating the viability of a service corporation's brokerage program and the level of risk presented to the parent thrift.

Policy on Sales of Investment Products and Referral Activity

Thrifts, through their service corporations or third party lease arrangements, provide on-premises securities brokerage services to their customers. These services and other program features should be described in a written statement, adopted by management *of the thrift or the service corporation*, that also contains a summary of internal controls that serve to minimize the level of risk involved.

The OTS's examination authority covers all on-premises sales or recommendations of investment products by a thrift's service corporation or a third party, as well as sales that result from customer referrals for which the thrift receives a benefit. It includes sales of investment products and advisory services initiated from the thrift's premises by telephone or by mail. The purpose of the review is to determine the adequacy of internal controls in containing the level of risk presented to the thrift and minimizing potential customer confusion between FDIC-insured and non-FDIC insured investment products. (Refer to Handbook Section 340, Internal Controls, for a detailed discussion of reviewing and evaluating the adequacy and effectiveness of internal controls.)

In providing on-premises securities brokerage services or customer referrals, internal policies and procedures should, at a minimum, incorporate the operating safeguards set forth in TB 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products. These general safeguards are described below and pertain to the following areas of the brokerage program review:

- Arrangements with third parties;
- Location of on-premises investment advisory and sales activities;

- Advertising and promotional materials;
- Disclosures;
- Sales practices and supervision of personnel;
- Compensation structures; and
- Systems for monitoring operations.

Since the OTS has traditionally only permitted securities brokerage activities through a service corporation, more specific requirements are set forth in 12 CFR § 545.74 and are also discussed in the latter part of this Section. Additionally, 12 CFR §§ 563.41 and 563.42 will apply when a thrift affiliate provides services to the brokerage program through a third party arrangement.

Third Party Arrangements

In light of the substantial costs associated with establishing a brokerage dealership and the extensive securities regulatory environment, the most common situation is for a service corporation to enter into an agreement with an established broker-dealer. The financial and managerial commitment of the service corporation and the level of profits that the entity retains will vary based on the brokerage program's structure, the services involved, and the terms of any written agreement with third parties.

Third parties can offer a full range of investment and administrative services to a securities brokerage subsidiary or a thrift. In providing these services, third parties (i.e., broker-dealers, marketing firms) may consider the thrift's brokerage operation as a conduit for sales, or primarily seek income by charging fees for administrative services.

There are a number of different ways in which a securities brokerage program may be structured. Marketing firms, depending on the needs of the service corporation, may establish and manage the operations or simply provide support functions. Broker-dealers can provide a broad scope of investment products including mutual funds, stocks, bonds, municipal bonds, mortgage-backed securities, annuities, or limited partnerships.

There are essentially two types of third parties that, for purposes of this Section, are referred to as "non-affiliates" and "affiliates." The term affiliate is defined in 12 CFR § 563.41(b)(1). There are general

areas of review for determining the risks associated with any third party arrangement. To the extent that a third party is a thrift affiliate, additional OTS regulatory restrictions and policy standards will apply.

Non-Affiliate Third Party Arrangements

Policies and procedures should contain standards for conducting an appropriate review of third parties that offer on-premises investment services and products. These controls should also ensure that the third party arrangements reflect the safeguards contained in TB 23-2 and comply with applicable OTS regulations and restrictions detailed in this Section. Additionally, any third party arrangements should be approved by the service corporation's board of directors.

Prior to establishing third party arrangements, service corporation management should thoroughly evaluate an entity and the quality of its services and investment products. The evaluation should be performed by personnel with appropriate knowledge, experience and analytical skills. The service corporation's files should document management's review of a third party's services and investment products and internal procedures in this area. For example, management should verify that: (1) the entity's business is approached with integrity; (2) consumer complaints, if any, are promptly addressed and are not indicative of poor overall operating practices; (3) there is a *history* of compliance with securities laws and regulations; (4) that disciplinary *histories are reviewed*; and (5) *all the products sold by the vendor meet the criteria set by the board of the thrift or the service corporation*.

An adequate review of investment underwriters or issuers and the quality of their products can prevent or limit the number of product liability lawsuits filed against the service corporation and, to the extent the corporate veil is pierced, the parent thrift. Service corporation management can also limit their risk exposure in this area by not offering highly speculative investment products such as commodity futures, real estate partnerships, or junk bonds. If such products are offered, however, appropriate safeguards (i.e., disclosures, customer/product suitability standards) should be employed to ensure the customer's awareness of the inherent financial risks of these types of investment products.

After an arrangement is established, the service corporation's board of directors and management should continue to review the third party's services and

investment products. Ongoing monitoring systems and periodic reporting procedures should ensure that the third party and its employees' activities comply with all contractual obligations, the thrift's internal policies and procedures, and applicable state and federal laws and regulations. Internal procedures should describe the types of reports that third parties must provide to service corporation management on a routine basis. Required reports might provide information on new account activity, findings revealed through internal compliance systems maintained by the senior securities principal, and sales activity exception reports that flag potential concerns regarding parameters that have been exceeded or unusual patterns or trends.

Affiliate Third Party Arrangements

While all third party arrangements should be thoroughly reviewed for compliance with regulations applicable to service corporation subsidiaries, arrangements with affiliates must also comply with the following OTS requirements and policy standards. (Refer to Section 400 of the Holding Companies Handbook for a detailed discussion of transactions with affiliates.)

Transactions with Affiliates

Sections 563.41 and 563.42 (Transactions with Affiliates) place quantitative and qualitative restrictions on loans and certain other transactions entered into by a thrift (or its related organization) and an affiliate. Section 563.42 contains specific restrictions on a thrift's purchases of securities from an affiliate when the thrift is acting as a fiduciary. In addition, § 563.41 prohibits a thrift, or its subsidiaries, from purchasing or investing in the securities of an affiliate.

Sales of Securities

Section 563.76 of the regulations generally prohibits on-premises sales of a thrift's or its affiliate's securities. A limited exception allows the sale of stock issued in connection with the conversion of a thrift from the mutual to stock form of ownership. TB 23a, Sales of Securities, clarifies this and other limited exceptions to the general prohibition in § 563.76.

Specifically, TB 23a provides that the OTS will not treat investment companies that are sponsored, advised, distributed, or administered by a thrift or its holding company, or a subsidiary of the holding company, as an "affiliate" for purposes of § 563.76.

TB 23a requires, however, that on-premises sales of an investment company's shares comply with safeguards that are comparable to those contained in § 563.76 and TB 23a. [Note: TB 23a provides that the investment company may be treated as a thrift affiliate under certain other regulations such as those that govern transactions with affiliates. Thus, the shares issued by the investment company would be shares of a thrift affiliate.]

Section 563.76 establishes certain requirements for thrifts that engage in on-premises sales of their (or an affiliate's) securities. One such requirement is that the thrift (or an affiliate) may not pay any commissions, bonuses, or comparable incentive compensation to its employees in connection with on-premises sales of its securities. Compensation consistent with industry norms, however, may be paid to securities personnel of registered broker-dealers.

Internal controls and policies should incorporate appropriate safeguards to ensure compliance with the above requirements and general policy standards contained in TB 23-2. Additionally, the OTS has, on a case-by-case basis, imposed additional restrictions on thrifts and their brokerage subsidiaries to address supervisory concerns that are specific to relationships with their securities affiliates.

Written Agreements with Third Parties

The service corporation's files should contain adequate documentation regarding its arrangements with third parties. Written agreements should sufficiently delineate all facets of the arrangement, and must be approved by the service corporation's board of directors. These agreements should, at a minimum, state the following:

- The functions or responsibilities of each party to the agreement;
- The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations and policy statements);
- Assurances of compliance with applicable laws, regulations and policies statements;
- The authority of the thrift or service corporation to conduct periodic reviews of the third party's activities to verify compliance with the terms of the agreement;

- Each party's right to participate in profits and obligations to share expenses;
- The types of third party services or investment products to be provided and related restrictions;
- Insurance requirements;
- Indemnification provisions; and
- Employee compensation programs and provisions for prior approval by the board of directors of any employment contracts.

A review of the agreements and records pertaining to third party arrangements provides an overview of the securities brokerage operations and reveals potential areas of risk that require further evaluation. Any contract between the service corporation and a third party should contain language that fully indemnifies the subsidiary and its parent thrift from liability attributable to the negligence, recklessness or intentional misconduct of the third party or its employees *as required by 12 CFR § 545.74(c)(4)(i)(C)*.

The thrift may not sign or otherwise be a party to its service corporation's agreement with a third party. This serves to insulate the thrift from the subsidiary's obligations and ensure that separate corporate identities are maintained. Thrifts may, however, enter into a written agreement to lease a portion of its office space to a nonsubsidiary broker-dealer or, to the extent that such arrangements may be authorized by the OTS, directly engage in securities brokerage activities. [Note: A thrift and its related organizations may not, absent prior OTS approval, engage in the lessee's operations. Also, these arrangements should be based on a bona fide lease and an equitable commission sharing arrangement or provide for the thrift to receive regular, fixed payments that reflect the fair market rental value of the property.]

Service corporation management must be able to demonstrate that internal controls are adequate to monitor a third party's compliance with written agreements. Adequate records pertaining to all brokerage activities should be maintained in a manner that facilitates a prompt review by management and regulators. In determining, for example, whether income is shared in an agreed upon manner, production reports that identify the number and types of sales for the service corporation and for the bro-

ker-dealer should be reviewed to determine whether they balance. This is particularly important if remuneration is based in any way on production.

Additionally, third party arrangements should be consistent with representations made to the OTS through the notification or application approval process. The service corporation's files should indicate whether there have been any changes involving third party arrangements since the last examination. A service corporation that terminates a contract with a broker-dealer to enter into a new contract with a second broker-dealer, must file a new notification or application with the OTS. If, however, a third party broker-dealer is acquired by another broker-dealer that assumes its existing contracts, the parent thrift may obtain a no-action letter from the OTS that permits the thrift to change broker-dealers without filing another notice or application.

The business plan of the thrift and its service corporation should also be reviewed to determine whether the third party arrangements are consistent with stated management strategies and objectives pertaining to the subsidiary's operations. Overall, the regulator's review of the brokerage program's agreements and internal controls should reveal whether established procedures, policies and prudent business practices are successfully implemented.

Location of Offices and Informational Materials

Internal controls should also ensure that the brokerage program is clearly distinguished from the thrift's traditional operations for minimizing potential customer confusion. It should be obvious to the casual observer that a brokerage dealership operating on the thrift's premises is a separate organization. For example, a service corporation generally should not conduct on-premises sales of investment products with a name similar to that of the parent thrift, except for conversion stock (see 12 CFR § 563.76), unless internal controls can adequately minimize the risk of customer confusion. As set forth in TB 23-2, investment products must not have a name that is identical to that of the thrift. Similar names are not permitted unless applicable requirements established by the SEC are observed and the sales program is designed to minimize the risk of customer confusion.

Specifically, the following practices should be implemented to ensure that the investment sales area is distinct and that sales literature and material does not convey any inaccurate or misleading impressions

about the nondeposit investment products offered.

- The area where nondeposit investment products are offered should be physically separated (i.e., walls, partitions, signs) from teller windows and desks where retail deposit-taking activities are offered;
- Literature and information on investment services should be clearly separate from material pertaining to traditional thrift products (i.e., rates for investment products should be posted separately from checking or certificate of deposit promotional literature, the thrift and brokerage program should have separate advertisements and pamphlets);
- Signs and literature should clearly state that investment products are not FDIC-insured;
- Statements provided to customers that contain deposit and securities brokerage account information should clearly separate the information and include the required minimum disclosures; and
- Under no circumstances should any employee, while located in routine deposit-taking areas (i.e., teller windows, new account desks), make general or specific recommendations regarding investment products or accept orders for such products.

Maintenance of Separate Corporate Identities

While the above safeguards are prudent business practices, they are also important to ensure compliance with regulatory requirements pertaining to the maintenance of separate corporate identities (§§ 571.21 and 563.37). These requirements are described in Handbook Section 610, and are an important aspect of the service corporation review. To comply with such standards, for example, leasing or rental contracts between a thrift and its subsidiary should be at terms that reflect the fair market value of the space being leased.

Additionally, § 571.21 provides that a thrift and its related organizations should operate without intermingling their respective business transactions, and keep separate accounts and records. It is common, however, for a thrift to provide customer information to its securities brokerage subsidiary. The OTS has not established a regulatory prohibition against

this practice, but has taken the position that the securities brokerage subsidiary should comply with the thrift's conditions regarding the use of the parent thrift's customer information. These procedures should comply with applicable state law. On the basis of legal or supervisory concerns, the OTS can, under § 545.74(b), limit access to or use of thrift customer information (i.e., if the information is used in a manner that increases the potential for customer confusion).

When separate corporate identities are not maintained, the parent thrift may be held liable for the contractual obligations of its subsidiary. A review of internal controls and any agreements between a service corporation and its parent thrift or a third party may assist in determining whether separate corporate identities are sufficiently maintained. (Refer to the discussion of "Maintaining Separate Corporate Identities" in Handbook Section 610.)

Content of Advertising and Promotional Materials

Advertising and other promotional materials should be clearly distinguished from that of the parent thrift's depository functions and must comply with the following standards:

- Advertising must not confuse transactions executed and investment advice provided through brokerage operations with federally insured deposits;
- Advertising must clearly state the name of the entity (i.e., service corporation, third party) that it is offering the nondeposit investment products;
- The broker-dealer must be identified in advertising:
 - The parent thrift's logo must not be used in the brokerage program's advertisements; and
 - Promotional material should not omit material facts or mislead customers regarding the characteristics of, and risks associated with, particular investment products.

Advertisements and promotional materials regarding brokerage services should be available to customers in those areas where securities brokerage functions are performed, and may also be placed at branch entrances. When the thrift includes the brokerage subsidiary's materials in mailings that contain thrift cus-

tomer account statements, these practices should be carefully reviewed to ensure that disclosures are adequate to minimize potential customer confusion and contain the required disclosures as outlined in TB 23-2. For additional information regarding OTS regulations on advertising, refer to Compliance Activities Regulatory Handbook Section 425, Advertising.

Oral and Written Disclosures

Because prospective brokerage customers tend to associate the name and logo of a thrift with the federal insurance that protects their deposits against loss, it is essential that adequate disclosures be made. When the name of the brokerage program (or its investment products) is similar to that of the thrift or its services are offered on the thrift's premises, unsophisticated customers may assume that the investment products are federally insured. For this reason the SEC presumes that similar names promote customer confusion. In order to be permitted to use a similar name, this presumption must be rebutted. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names).

The potential for customer confusion also increases when references are made, through investment sales presentations or materials, to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state funds, or private companies). These references should be followed by a clear explanation of the distinctions between such insurance coverage and FDIC deposit insurance. Thrift and service corporation management should ensure that all employees having customer contact receive adequate training on relevant insurance coverages. Internal procedures should also require that written and oral explanations of such insurance coverages are provided to all customers in accordance with established disclosure practices.

Management must ensure that oral and written disclosures are clear, conspicuous, and effective in minimizing customer confusion by fully distinguishing: (1) uninsured products from insured thrift deposits, and (2) brokerage services from deposit-taking functions of the thrift. On-premises sellers of investment products should disclose, in all sales presentations, advertising, confirmation forms, and account statements, the characteristics of the products being offered or sold. Specifically, TB 23-2 establishes the following required "minimum" disclosures that must be provided to customers:

- The products are not insured by the FDIC;
- The products are not deposits or other obligations of the institution and are not guaranteed by the thrift; and
- The products are subject to investment risks, including possible loss of principal invested.

Additionally, internal controls should address standards for providing customers with prudent disclosures regarding any fees, penalties, or surrender charges associated with specific investment products. These controls should also indicate the content and form of customer disclosures pertaining to material relationships between the thrift, its service corporation, an affiliate or an investment company whose shares are sold by the brokerage program.

Internal policies should also ensure that required disclosures are conspicuously stated in all advertisements, sales presentations, or other information (i.e., brochures) pertaining to the features of investment products. Disclosures should generally be presented on the front of a brochure, in the top portion of any text regarding investment products and at the beginning of sales presentations, customer referrals or solicitations. In addition, effective internal procedures in this area would include highlighting the required disclosures in a box, in bold type or with bullet points.

In reviewing the adequacy of internal procedures, the following regulatory requirements and policy standards regarding the timing and form of disclosures should be addressed.

Sales of a Thrift or Thrift Affiliate's Securities

For on-premises sales, 12 CFR § 563.76 requires that purchasers of a thrift's or an affiliate's securities must certify in writing that they have received specific disclosures on the nature of the securities being sold.

Sales of Other Investment Products

The minimum disclosures should be provided to the customer in the following manner:

- orally during any sales presentation;
- orally when investment advice concerning nondeposit investment products is provided; and
- orally and in writing prior to or at the time an investment account is opened.

In addition, at the time an investment account is opened, the seller of investment products should obtain a signed certification from customers acknowledging that the customer received and understands such disclosures. (Refer to the sample certification form attached to “Retail Investment Sales Guidelines for Banks” issued through a joint effort by six financial institution trade associations, including the Savings and Community Bankers of America and the American Bankers Association.)

Customer Referrals by Nonregistered Thrift Employees

Management should adopt standards pertaining to customer referrals by a thrift’s employees to the brokerage operation. ***Nonregistered thrift employees cannot give investment advice, make general or specific recommendations, qualify a customer as eligible to purchase nondeposit investment products or accept orders for such products, even if unsolicited.***

Appropriate Sales Practices

Liability to customers is a primary area of concern in assessing the level of risk presented to the thrift. A broker-dealer that charges excessive mark-ups or makes fraudulent representations of a general nature (i.e., implies that an investment is FDIC-insured when it is not) can be a source of liability to the service corporation and, when separate corporate identities are not maintained, to the thrift as well. The brokerage program must also be conducted in a manner that insulates the thrift from liability under the anti-fraud provisions of the federal securities laws.

Adequate controls should be implemented to ensure that sales practices are appropriate and that registered representatives comply with management’s internal policies, applicable regulations and restrictions of the OTS and securities regulators. These controls are particularly important to contain risks associated with inappropriate sales practices involving misrepresentations or ineffective disclosures provided to customers.

TB 23-2 and applicable OTS regulations establish minimum standards pertaining to customer disclosures. Risks that are specific to a particular product, the program’s sales techniques, a referral arrangement or relationships with affiliates may require additional disclosures. These disclosures must enable customers to make well-informed investment decisions that serve their own best interests.

There are three primary areas that should be addressed in policies pertaining to sales practices: (1) suitability standards; (2) training; and (3) monitoring systems. Management should ensure that the broker-dealer and sales representatives employ prudent practices in the following areas.

Suitability Standards

The brokerage operation has an obligation to provide customers with products suitable to their needs. Poor or inappropriate investment recommendations attributed to brokerage advisory services will not stand the thrift (or its service corporation) in good stead with the public.

The brokerage program’s policies should document minimum standards that registered representatives must employ to determine whether to recommend a particular investment product to a customer. Such standards require that sales staff obtain sufficient customer information (i.e., age, education, financial and tax status, investment objectives, retirement/financial plans), for making such a determination. For example, an elderly couple that seeks investment products to provide a steady source of income and preservation of capital in the near future should not be advised to invest their life savings in a highly speculative mutual fund.

The brokerage program’s internal controls should require that sellers of investment products comply with applicable “suitability” and “know your customer” standards or related customer protection practices established by securities laws, regulations or the rules of the self-regulating organizations (SROs), ***such as the NASD***. Such standards generally provide that sales representatives should have reasonable grounds for recommending that a certain investment product is suitable for a particular customer. Also, the sales representative must believe that the customer is reasonably capable of evaluating, and financially able to bear, the risks associated with an investment recommendation. Customer information that forms the basis for recommending particular transactions should be thoroughly documented in the brokerage dealership’s files and updated periodically.

The broker-dealer should be required to periodically certify that it complies with any applicable suitability requirements and customer protection rules as required under 12 CFR § 545.74(c)(4)(i)(D). In addition, service corporation management should document procedures for monitoring the brokerage pro-

gram's success in complying with established policies pertaining to customer suitability standards. Such monitoring might include periodic reviews of any records on regulatory violations by the company and its sales representatives, customer complaints, or post-audit reviews of a representative sample of transactions. Management should be able to demonstrate that any concerns regarding customer suitability issues have been adequately investigated and resolved (i.e., through training or other actions).

When weaknesses in internal controls are revealed, the regulator should review management reports to identify patterns in order to evaluate concerns regarding appropriate sales practices (i.e., whether a significant number of mutual fund redemptions have occurred after fairly short holding periods). To select sales for review, the regulator should consider patterns related to, for example, specific marketing strategies (i.e., designed for retirees), new account activity, customer complaints, or the performance of representatives with low or high levels of sales activity.

Concerns pertaining to specific sales patterns may require further review beyond customer suitability issues. For example, based on a review of relevant reports maintained by the broker-dealer, a substantial number of "early" mutual fund redemptions may be attributed to improper practices by individual registered representatives, a problem with the investment product, or deficiencies in the employee training program.

Training

In addition to monitoring sales practices, service corporation management can minimize the thrift's exposure to loss by ensuring that employees are adequately trained. Internal policies should establish minimum qualifications and training procedures for the distinct types of brokerage personnel. Management controls should ensure that third party broker-dealers and their employees are appropriately registered with the SEC, NASD, and state securities regulators. In addition to qualifications and training required by securities regulators, brokerage personnel must obtain adequate knowledge in the following areas:

- products involved, including applicable legal restrictions;

- internal policies and procedures of the service corporation and its parent thrift; and
- OTS requirements and restrictions.

Limitations on an employee's authority, proper disclosure practices, and customer suitability standards should be set forth in training materials. Internal policies and records should clearly describe the responsibilities and specific authority assigned to each "type" of employee (i.e., clerical, registered sales representatives, supervisor). Documentation should also indicate the manager responsible for supervising specific employees or types of securities brokerage activities. At a minimum, training material and brokerage policies should address the following areas:

General Restrictions on Sales Representatives' Practices

Brokerage employees should not, without prior OTS approval, engage in the following activities:

- make recommendations regarding securities of issuers that have lending relationships with the thrift, its subsidiaries, or affiliates;
- solicit transactions in specific securities from customers; and
- condition the execution of securities transactions on a customer's use of the service corporation's or a third party's safekeeping services (i.e., holding or transferring actual securities on behalf of the customer).

Training materials should also ensure that sales representatives are thoroughly familiar with overall permissible brokerage activities that are preapproved or specifically authorized by the OTS or FDIC. Operating restrictions and standards imposed by the OTS or FDIC through supervisory letters, approval orders or policy statements should be reflected in internal policies and procedures. For example, standards pertaining to permissible conduct by registered securities brokerage employees should generally be limited to:

- soliciting interest in the program's overall investment products and advisory services;
- making recommendations in response to a request by a customer; and

- not recommending specific nondeposit investment products through “cold calls,” or other unrequested contacts with a potential customer. [Note: This is not a prudent practice since there can be no reasonable determination as to customer suitability concerns nor the individual’s ability to understand the product’s features and financially bear related investment risks.]

In addition, a broker-dealer may limit various classes of personnel (i.e., based on their qualifications and training) from offering their own assessment of the market or making recommendations based on their perception of the customer’s investment needs. When a customer raises a question or seeks advice on a matter beyond the knowledge or authority of the representative to answer, the employee should forward the customer’s request to registered securities principals (either on-premises or an off-site information center) with expertise in that area. Training programs must, therefore, ensure that employees understand the limits of their authority.

Registered Representatives that are Dual Employees

As mentioned, joint ventures and other arrangements between the service corporation and a third party broker-dealer may staff sales operations with individuals that are also employed by the parent thrift. These individuals are referred to as dual employees. The potential for customer confusion is greater when dual employees have customer contact on behalf of both the thrift and the brokerage subsidiary. Thus, additional safeguards may be appropriate to address such risk. Policies and employee training material should include activities restrictions and responsibilities that apply to brokerage employee functions. For example, dual employees should not, while located in routine deposit-taking areas (i.e., teller windows), make general or specific recommendations regarding investment products, or accept any orders for such products.

Nonregistered Employees

Employees that are not registered representatives may perform brokerage functions that are ministerial or clerical in nature. When the brokerage program is conducted through a service corporation subsidiary, prior OTS approval is required under 12 CFR § 545.74(c)(4)(ii)(G) for these employees to engage in additional responsibilities. For example, nonregistered employees may not, under § 545.74,

accept or deliver money or securities nor take orders to execute securities transactions. Thrift employees (sole or dual) may, in accordance with thrift policies, refer customers to individuals who are designated and trained to assist customers interested in securities brokerage services.

Thrift Employees

OTS allows tellers and other employees to refer customers to individuals who are specifically trained and designated to assist customers interested in the purchase of investment products. The thrift’s internal policies should clearly state that tellers may not sell nondeposit investment products nor offer investment advice to customers by making recommendations or discussing the features of such products. There are additional restrictions on their activities and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Use of the Thrift’s Customer Information

Employee training materials should describe the brokerage program’s procedures on the appropriate use of the thrift’s customer information and identify which employees are authorized to use the information. These materials should address specific steps for minimizing customer confusion when the information is used to contact thrift customers whose CDs are due to mature. Specifically, such contacts should be conducted in a manner that alerts customers to the features and risks associated with nondeposit investment products and that the products are not offered by the thrift nor FDIC-insured.

Monitoring Systems

As stated above, thrift or service corporation management should conduct an initial review of broker-dealers prior to entering into any written agreements. Once an agreement is established, systems should be implemented to review a broker-dealer’s activities. For example, a periodic review of consumer complaints can reveal deteriorating trends in a broker-dealer’s business practices (i.e., misrepresentations, poor disclosures) and the quality of investment-related products. Information on consumer complaints against the service corporation or a third party broker-dealer might be available from the Better Business Bureau and other consumer organizations. Also, the OTS Consumer Complaint System will indicate whether any complaints have been filed with the OTS.

Standards for reviewing the conduct of individual sales representatives and identifying sales patterns should be documented in the written policies and procedures adopted by the service corporation's board of directors. These standards should be established as part of a comprehensive monitoring system and might provide for:

- routine daily management and oversight of sales representatives by the broker-dealer;
- requirements relating to prior management approval for opening new accounts or executing transactions that exceed a certain dollar amount;
- exception reports that identify transactions that exceed established parameters;
- compliance with applicable rules and regulatory requirements of the OTS and securities regulators; and
- periodic comprehensive reviews of sales representatives' practices (i.e., sampling transactions for compliance with customer/product suitability standards, surveying customer satisfaction through questionnaires, evaluating the nature of any customer complaints or disciplinary actions initiated by securities regulators).

Management's controls with respect to the security brokerage process should ensure that the service corporation's business is conducted in accordance with applicable regulatory constraints and supervisory restrictions. Adequate oversight procedures for monitoring sales practices can reveal unethical and illegal practices such as the "churning" of customer accounts (i.e., causing the rapid turnover of a client's accounts for the sole purpose of earning commissions).

Compensation Structures

The structure of compensation programs should also minimize the potential for abusive practices. The incentive compensation structures adopted by service corporation management tend to be similar to those found throughout the securities industry. Compensation structures for each class of personnel should be established in written policies and procedures and be available for review by the regulator. The brokerage program's compensation structures should be clearly separate from those of the thrift.

Registered representatives may receive incentive compensation, such as commissions, bonuses, and awards provided their practices are prudent and comply with brokerage program's policies and procedures regarding, for example, customer suitability considerations and adequate disclosures.

Management should be able to demonstrate that compensation paid to dual employees is reasonable. Internal policies and procedures should identify whether commissions and bonuses are available to dual employees, and all employees with customer contact regarding investment services should be trained to observe the boundaries of permitted activities.

Tellers and other thrift employees may receive fees for referring customers to the securities brokerage subsidiary, however, only a one-time nominal fee may be received for each referral. (See Appendix B.) Compensation and referral fees paid to dual and sole brokerage employees can be of concern insofar as these may bias employees to refer business to the securities products rather than those of the thrift. Such incentives may also result in aggressive sales practices. Management should monitor investment product sales activity for individual sales representatives and evaluate whether any patterns reveal improper practices (i.e., concentrations in the types of products sold that may indicate whether recommendations are driven by incentive compensation).

Internal controls throughout all aspects of securities brokerage activity are important to ensure that incentive compensation programs do not lead to improper sales techniques or unethical tactics in an attempt by sales representatives to reap greater financial rewards. Additionally, compliance and audit personnel should not receive any incentive compensation related to the brokerage program's operations. On the basis of supervisory or legal concerns, the OTS may, under § 545.74(a)(5), object to any element of a service corporation's compensation program.

Conflicts of Interest

Thrifts and their subsidiaries should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The policy should address those entities and individuals that are providing services through third party arrangements. Specifically, sales of investment products to trust accounts (or other fiduciary accounts in which the parent thrift exercises discretion) may result in conflicts of interest and are generally prohibited.

(Refer to the Trust Activities Handbook for guidelines on prudent practices pertaining to fiduciary accounts.)

Inventory Risk

The brokerage program faces inventory risk, or risk that the actual securities will be lost or stolen, if kept on the premises. While this is not often a major concern because the broker-dealer is acting for the customer, there are times when the broker-dealer will hold the securities until the customer picks them up. Systems should be in place to ensure that no inventory is maintained, and that safety measures are taken for the transportation of securities. Procedures should also be employed to prevent securities orders from being lost.

Assessment of Service Corporations' Securities Brokerage Operations

In addition to determining whether management has successfully implemented the safeguards detailed in TB 23-2, the service corporation's operations must be reviewed for compliance with 12 CFR § 545.74. To facilitate OTS examinations, as well as audits, 12 CFR § 563.170 requires that service corporations establish and maintain adequate records that provide an accurate and complete picture of all business that the entity transacts. Information pertaining to the service corporation's operations can, therefore, be obtained from the service corporation's files and interviews with the securities principal responsible for brokerage program oversight. A review of these files should provide an understanding of the risk assumed by a service corporation and a basis for evaluating the adequacy of management's risk containment measures.

Section 545.74(c)(4) sets forth the operating restrictions that apply specifically to a service corporation's securities brokerage activities. Additional regulatory requirements that generally apply to all service corporation activities (i.e., investment limitations, financial reporting standards, notification procedures) are detailed in Handbook Section 610.

Preapproved Securities Brokerage Activities

A service corporation may only engage in securities brokerage activities that are preapproved or have been authorized by the OTS or FDIC. Section 545.74(c)(4) lists preapproved securities brokerage activi-

ties and pertains solely to a federal thrift's authority to conduct such operations through a service corporation. State laws should be consulted to determine whether similar authority exists for state-chartered associations. As detailed in Handbook Section 610, a state savings association's authority to conduct activities through a service corporation generally may not, under 12 CFR § 303.13, exceed those permissible for a federal thrift unless prior FDIC approval is obtained. The scope of preapproved securities brokerage activities is limited to the following categories of services: (1) executing trades on an agency and riskless principal basis and (2) investment advisory services.

For securities brokerage activities to qualify as preapproved, the service corporation must, to the satisfaction of the regulator, comply with the following requirements established in § 545.74(c)(4)(i).

- Activities must be conducted in a physical area that is clearly identified and distinguished from the areas where the parent thrift's depository functions are performed. Areas may be physically defined in various ways including the use of partitions, plants, platforms and kiosks. Advertising must also distinguish a subsidiary's services from those of the parent.
- Third party broker-dealers must indemnify the service corporation and parent thrift for any liability arising from the negligence, recklessness or intentional conduct of the broker-dealer or its employees.
- The senior securities principal of the brokerage dealership must maintain adequate systems and controls that detect and prevent any violations of applicable securities laws or rules of the SROs. Annual certifications that such systems are maintained and that the brokerage program complies with applicable securities rules and regulations must be filed with the OTS.
- The service corporation or broker-dealer must not condition or tie the provision of brokerage services to a customer's use of its services or those of an affiliate of its parent thrift.

A brokerage subsidiary that limits its operations to preapproved activities can, nevertheless, present material risk to the parent thrift. This risk increases when management is negligent in implementing or maintaining adequate operating controls and monitoring procedures. The service corporation's manage-

ment should be able to demonstrate that the brokerage program operates within the scope of activities that are preapproved or specifically authorized.

Activities Not Authorized as Preapproved

A service corporation's parent thrift must file an application to seek prior OTS authority to engage in an activity that is not preapproved. (Refer to "Other Reasonably Related Activities" in Handbook Section 610.) The OTS has, for example, on a case-by-case basis allowed service corporations to engage in the underwriting and marketing of mutual fund shares or products of an investment company. Section 545.74(c)(4)(i) specifically states that the following activities are not authorized as preapproved:

- executing principal securities transactions, making markets in securities or underwriting securities;
- paying referral fees to the parent thrift's employees unless a "no-action" letter is obtained from the SEC and prior OTS notice is provided regarding the size and manner of referral fee payments. (The SEC no longer issues individual no-action letters. (See Appendix B.)) ;
- soliciting transactions in a particular security;
- indemnifying a broker-dealer to a greater extent than the service corporation is being indemnified;
- extending margin credit to investors; or
- allowing nonregistered representatives to engage in other than clerical and ministerial work.

Management must be able to demonstrate that all securities brokerage services are conducted in accordance with the stated purpose of the service corporation, any OTS approval order or representations made to the OTS through the notification process, and the applicable regulatory and policy standards discussed throughout this Section. The OTS Thrift Information Exchange Systems (TIES) is a source of information for obtaining nonstandard approval conditions for a specific service corporation application.

In addition to any OTS operating restrictions, a thrift subsidiary that operates as a broker-dealer

must also comply with SEC rules and regulations, including registration requirements. When the service corporation itself is not a broker-dealer, and establishes a referral fee program instead, it must comply with the SEC's policy on networking arrangements to legally receive referral fees and rely on the broker-dealer for all technical matters relating to securities. This policy pertains to whether depository institutions (including thrifts and their service corporations) themselves, or their nonregistered employees, are required to register as broker-dealers when brokerage services are offered on their premises.

Prior to establishing a service corporation referral fee program, under § 545.74(c), the parent thrift must obtain an SEC no-action letter. This letter ensures that enforcement action will not be initiated against the thrift, its subsidiary and nonregistered personnel for failing to register with the SEC. The SEC, however, no longer provides such letters and instead has issued a comprehensive no-action letter, in Re Chubb Securities Corporation, dated November 4, 1993. This letter represents the SEC's policy on networking arrangements and applies to all referral fee programs established by depository institutions and their subsidiaries. (See Appendix B, SEC Policy on Networking Arrangements.)

In light of the change in SEC policy, the OTS will not enforce the no-action letter requirement when the following criteria are met:

- the parent thrift must provide an opinion from counsel or the senior securities principal responsible for brokerage program oversight, with subsequent certification from the thrift's board of directors, that any referral fee arrangement complies with applicable SEC regulations and policies; and
- the regional office has no supervisory objections to the referral fee arrangement.

Under the SEC's policy, referral fees paid to nonregistered employees must (1) be nominal and unrelated to the volume of securities traded by the customer, (2) be limited to one fee per customer referred, and (3) not include other compensation such as trips, free meals, or monetary awards. The broker-dealer must also provide manuals on appropriate conduct to nonregistered employees that specify the limits on their permissible activities. Additionally, supervisory employees must not receive any fees for referrals made by their subordinates.

As can be seen, the risks presented to the parent thrift by its brokerage subsidiary can vary among the distinct types of brokerage programs. Thus, an understanding of the service corporation's approach to brokerage operations can assist the regulator in identifying potential areas of risk and establishing an appropriate scope of review. Since service corporation brokerage operations typically involve referral fee arrangements, the competence of third parties and the quality of their services/products are an important factor in determining the level of risk assumed by the service corporation.

Overall Risk Assessment

In determining the overall risk presented to the thrift by a securities brokerage program, the basic aspects of permissible securities brokerage activities and management controls for containing risk, as discussed in this Section, should alert the regulator to potential unsafe and unsound practices. Given the different types of brokerage programs and investment products that are offered to customers, the discussion has necessarily focused on general types of brokerage program structures and various risks that can increase the thrift's exposure to loss and lead to customer confusion.

While the procedures that follow relate primarily to the securities brokerage program, the regulator's review of service corporations should also address general business concerns and the areas of review detailed in Handbook Section 610, Overview. The extent to which procedures are performed will depend on a number of factors, including the types of securities brokerage activities, specific products offered, relationships with affiliates, third parties and the parent thrift, the size of the business, and those factors detailed in the Overview Section.

It should be kept in mind that it remains common for securities firms to be established in periods of high trading volumes, and to do well during those times. They may, however, suffer cutbacks or go out of business when volume declines. Therefore, it is appropriate to evaluate the service corporation's future prospects for weathering the storms of the markets, and any measures that have been taken to prepare for the next low point in the cycle. Management expertise and competence is an important factor in assessing the service corporation's long-range planning strategies.

Examination Objectives

To determine the level of risk that securities brokerage activities present to the thrift and to recommend corrective actions as necessary.

To determine whether the required disclosures are made to customers.

To determine the effectiveness of internal controls that distinguish the securities brokerage program from the thrift's traditional activities.

Examination Procedures

Pre-Examination Analysis

1. Review a copy of:

- The most recent NASD, SEC or state examination report(s) and any reports pertaining to customer complaints or disciplinary actions initiated by securities regulators against the broker-dealer or any of its employees;
- The NASD and state regulatory license for each state in which the securities brokerage program operates;
- The production and financial reports for the securities brokerage program and any associated third party;
- Reports pertaining to internal compliance reviews;
- The most recent public accounting report; and
- All written agreements and conditions of approval pertaining to the securities brokerage program.
- Thrift Financial Report Schedule CSI-Mutual Fund and Annuity Sales.

2. Determine the types of activities that the brokerage program engages in, its structure (i.e., lessee, joint venture, turnkey, referral) and the investment products offered (i.e., mutual funds, annuities, equity securities).

3. Verify that the association received OTS approval prior to engaging in securities brokerage activities and is in compliance with approval conditions.

Sales of Investment Products and Referral Activity*Level I*Internal Controls

4. Determine if internal policies and procedures have been approved by the appropriate board of directors (service corporation or thrift) and whether they are sufficiently detailed.

5. Verify that the senior securities principal maintains adequate systems to detect and prevent any violations of securities, laws, regulations or rules.

Third Party Arrangements

6. Verify that agreements with third parties exist, and determine that:

a. They were approved by the appropriate board of directors (service corporation or thrift);

b. They contain, at a minimum, provisions that address the following:

- The functions and responsibilities of each party;
- Compliance with applicable securities laws, rules and regulations;
- The conditions of the arrangement (i.e., activities restrictions, compliance with OTS regulations, policy statements, and management's internal controls);
- Access to the third party's records;
- Indemnification of the thrift (and its service corporation, if applicable) for potential liability resulting from the actions of its employees; and
- Employment contracts offered to dual employees.

c. If the third party agreement is between the thrift's subsidiary and a third party, verify that the thrift is not a party to the agreement.

7. Determine whether the thrift (or its service corporation) has established adequate procedures for evaluating third parties and the quality of their services or investment products.

- Is the evaluation performed by personnel with

appropriate knowledge, experience and analytical skills?

- Are the procedures sufficient to ensure that the third party is financially stable and approaches its business with integrity? (Are consumer complaints reviewed along with any examination reports of the appropriate regulator(s)?)
- Do records document periodic assessments by management of the quality standards and monitoring systems used by the senior securities principal for each type of investment product? (Is a nationally recognized rating system or a thorough analytical process used?)

Location of Offices and Investment Sales Activity

8. Determine whether prudent internal controls are employed to ensure that it is obvious to prospective customers that securities brokerage services are offered by a separate entity, not the thrift, and determine whether:

- The area where nondeposit investment products are offered is physically separate from teller windows and other areas where retail deposit-taking activities are offered;
- Literature and information on investment services are located in areas that are clearly separate from material on traditional thrift products (i.e., the brokerage program's signs and advertisements are not located at teller windows, rates for products are posted separately); and
- Employees, while located in the routine deposit-taking areas (i.e., teller windows, desks where CDs can be purchased), are not permitted to make any recommendations regarding nondeposit investment products or engage in any activities related to offering or selling such products.

Content of Advertising and Promotional Material

9. Determine whether the brokerage program's advertisements and other promotional materials are clearly distinguished from that of the thrift's depository functions and are not misleading.

- Do materials contain the thrift's logo or terms such as "guaranteed" or "no risk" or other misleading terms?

- Is the entity offering the nondeposit investment products identified as the seller as required?

Note: If a concurrent compliance examination is scheduled that includes Section 425, Advertising, simultaneous review should be considered as these examination procedures overlap.

Oral and Written Disclosures

10. Determine the adequacy of disclosure policies through a review of training manuals, internal policies and materials available to customers (i.e., advertisements, brochures, prospectuses, offering circulars). Any “No” answers violate OTS policy.

a. Do procedures ensure that the required minimum disclosures are provided to customers: (1) the products are not insured by the FDIC, (2) the products are not deposits or other obligations of the institution or guaranteed by the thrift, and (3) the products are subject to investment risks, including possible loss of principal invested?

b. Are the required minimum disclosures made:

- Orally during sales presentations or when advising customers on investment products?
- In writing prior to or at the time an investment account is opened?
- Conspicuously, such that disclosures are: (i) located on the front of materials, in the top portion of text or at the beginning of sales presentations, customer referrals or solicitations, or (ii) highlighted in a box, with bold print, or with bullet points?

c. Are all fees, penalties, or surrender charges listed?

d. Do disclosures accurately identify material relationships between the brokerage dealership and an affiliate or investment company whose shares are offered to customers?

e. Are prospective customers advised to review information such as offering circulars or prospectuses before purchasing an investment product, if required by law, rule or regulation?

f. Are any references to insurance coverage provided by an entity other than the FDIC (i.e., SIPC, state

funds or private companies) followed by a clear and accurate explanation of such coverage?

g. Are customers required to sign a certification form acknowledging the characteristics of, and disclosures received about, nondeposit investment products?

Similar Names

11. Determine whether thrift management can demonstrate that applicable SEC requirements are observed when the name of investment products is similar to that of the thrift. (Refer to Appendix A, SEC Policy on Bank Mutual Fund Names.)

Use of a Thrift's Customer Information

12. Determine the adequacy and appropriateness of internal procedures regarding the use of the thrift's customer information by the broker-dealer. “Yes” answers are appropriate.

- Does the policy comply with applicable state laws?
- Is it clear that only designated personnel may use the information?
- Are adequate measures taken to minimize potential customer confusion when, for example, the information is used to contact holders of CDs that mature in the near future?

Compensation

13. Confirm that the senior securities principal has established internal policies that describe the authority, responsibilities, and method of compensation for each class of personnel and that a supervisor has been designated for each area of the brokerage program's operations.

14. Determine whether internal controls serve to detect and prevent improper sales techniques or unethical practices attributable to incentive compensation programs.

- When bonuses are offered as additional incentives, assess whether qualifications for the bonus increase the potential for aggressive sales practices or unethical practices (i.e., churning of accounts, providing misleading information). (Are bonuses dependent upon the sale of specific investment product(s)?)

Referral Fees and Practices

15. When the thrift is not registered as a broker-dealer, determine whether thrift management can demonstrate that a referral fee arrangement complies with the SEC requirements. (Refer to Appendix B, SEC Policy on Networking Arrangements.)

16. Evaluate the adequacy of the thrift's internal policies regarding customer referral practices.

- Do procedures provide for other than a one-time, nominal fee for each referral?
- Do fees depend on whether a transaction occurs?
- Are referrals made in a manner that effectively distinguishes investment products from FDIC-insured accounts?
- Is it clear that tellers are trained in acceptable referral practices and are prohibited from discussing the features of investment products, soliciting sales, or offering investment advice?

Dual Employees

17. When dual employees are registered representatives:

a. Determine the adequacy of safeguards for avoiding customer confusion. Any "No" answers indicate a violation of OTS policy.

- Are brokerage services performed in areas segregated from retail deposit-taking areas, as required?
- Do sales staff comply with the requirement that they identify the company that they represent?
- Are tellers dual employees? Are their teller functions conducted totally separate from securities brokerage activity?

b. Determine that compensation arrangements do not provide for inappropriate incentives.

Nonregistered Employees

18. Verify that internal controls ensure that the functions performed by nonregistered brokerage personnel are limited to those of a clerical or ministerial nature and consider whether nonregistered person-

nel are prohibited from assisting customers in completing forms for brokerage services and providing general investment advice, even if unsolicited.

Training and Qualifications

19. Evaluate whether the thrift's policies and procedures are sufficient to ensure that brokerage personnel are professionally qualified and adequately trained. "Yes" answers are appropriate.

- Has the broker-dealer established the qualifications and training requirements for each class of brokerage personnel?
- Is adequate training provided for each type of investment product that is sold or recommended?
- Do standards exist to monitor sales personnel such as sampling transactions, or requiring supervisor approval for new accounts and transactions that exceed established parameters?

Suitability Standards

20. Determine the adequacy of the broker-dealer's monitoring systems for ensuring that investment recommendations are "suitable" for a particular customer and determine whether:

- Recommendations are based on a reasonable assessment of the customer's financial position, objectives, tax status, age, and ability to understand and bear the investment risks;
- Standards are used to recommend products in amounts, and with terms and features, that are consistent with the customer's financial position and goals;
- Supporting documentation is maintained in customer files, updated periodically, and sufficient to provide a prudent analysis;
- Post-audit reviews of a representative sample of transactions are routinely performed; and
- Broker-dealers periodically certify that they comply with applicable rules of the SEC, SROs and states.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions

derived from performance of Level I procedures.

Level II

Third Party Arrangements

22. Evaluate whether internal controls are effective in monitoring a third party's compliance with the terms of a written agreement. (Do records indicate that commission income is being split in an agreed upon manner? Does the third party pay its own expenses?)

23. Verify the financial soundness of third parties that provide services or investment products on the thrift's premises or through an arrangement with a thrift subsidiary.

Internal Controls

24. Confirm that internal controls and procedures have been established to ensure compliance with board approved policies and procedures and determine whether:

- The compliance program is independent of the brokerage program's sales function;
- Post transaction quality controls have been implemented (i.e., exception reporting systems, reviews of customer satisfaction, and internal and external audits); and
- The compliance program, at a minimum, includes a system to monitor customer complaints, investment sales activity and customer accounts to detect and prevent improper practices.

25. Determine whether adequate procedures are established for handling any customer complaints or disciplinary actions initiated by securities regulators.

26. Determine the adequacy of internal controls in preventing situations that could potentially lead to a conflict of interest. (Is the conflict of interest policy revised periodically? Is it clear that representatives should not recommend securities issued by entities that borrow from the thrift?)

27. Determine whether systems are in place to ensure that no inventory of securities are maintained on the brokerage program's premises. (Do adequate

security measures exist for the transportation of securities? Are procedures followed that prevent orders from being lost?)

Evaluation of Business Plan Projections

28. Determine whether the brokerage program's operating results are consistent with business plan projections and that management periodically addresses long range strategic planning.

29. Evaluate the securities brokerage program's operating results and the volume of business against business plan estimates for overall operations and specific types of investment products. (Thrift management should be able to explain material variances.)

30. Determine whether management routinely reviews reports on customer mix and market surveys or other appropriate analyses and that the brokerage program's operating projections are supported by adequate documentation.

31. Determine whether reports provided to management on nondeposit investment sales activity are sufficient to determine trends or patterns that may require further review (i.e., a substantial number of mutual fund redemptions after fairly short holding periods, concentrations pertaining to specific investment products or types of customers).

32. Evaluate the thrift's procedures to implement corrective action in response to internal weaknesses or violations of applicable laws or regulations identified through monitoring systems, internal audits, and examinations by the OTS or securities regulators.

Service Corporations' Securities Brokerage Program

33. Perform the appropriate procedures in Handbook Section 610, Overview.

34. When reviewing compliance with regulatory requirements specifically applicable to securities brokerage operations conducted through service corporations (12 CFR § 545.74(c)(4)), management should, unless prior OTS approval is obtained, be able to demonstrate that:

- Securities brokerage activities do not involve executing principal securities transactions, making markets in securities or underwriting securities;

- Referral fees are not paid to the parent thrift unless the brokerage program complies with OTS restrictions and the SEC's policy on networking arrangements (refer to Appendix B, SEC Policy on Networking Arrangements);
- The broker-dealer does not solicit transactions in a particular security;
- The broker-dealer is not indemnified to a greater extent than the service corporation and parent thrift are being indemnified; and
- The service corporation and parent thrift are not extending margin credit to investors.

35. When the service corporation is not registered as a broker-dealer, verify that an opinion of counsel, or of the senior securities principal, states that any referral fee arrangement complies with the SEC's policy on networking arrangements as detailed in Appendix B. The opinion should be certified by the thrift's board of directors. (See Appendix B.)

Thrifts' Third Party Lease Arrangements

36. When a third party leases space directly from the thrift, confirm that there is a bona fide lease agreement that provides for fair market rent or an equitable commission sharing arrangement. Ensure that the thrift (or its subsidiary) does not engage in the lessee's operations.

Third Party Arrangements with Affiliates

37. When third party arrangements involve thrift affiliates, determine whether management can demonstrate that established internal controls are adequate to ensure that the thrift, or its subsidiary, complies with the restrictions detailed in §§ 563.41 and 563.42 of the OTS regulations.

38. Determine whether on-premises sales of a thrift's securities, or those of an affiliate, comply with the restrictions in 12 CFR § 563.76 and are performed in a manner that is consistent with the safeguards listed in TB 23a, Sales of Securities.

39. Ensure that the *Objectives* of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Proprietary Funds

40. Review proprietary fund sales programs to determine that:

- *oral and written disclosures are made, prior to the purchase of shares, of all relationships between the thrift, or its affiliates, and the fund; and*
- *proprietary funds do not have names identical or similar to the thrift.*

41. Review compensation arrangements for proprietary funds. Determine the effect of any difference in compensation structure. Review suitability documentation to ensure that compensation is not a factor in determining suitability.

42. Determine whether a contingency plan has been established for handling adverse events, such as a sudden market downturn or periods of heavy redemptions.

43. Review the association's earnings and evaluate:

- *profitability of activities including any investment advisory fees the association may receive; and*
- *income and expense from proprietary fund sales, investment advisory and proprietary fund management activities, as a percentage of noninterest income and expense.*

44. Review investment history of proprietary funds to determine that:

- *fund investments are in line with disclosures given in prospectus; and*
- *fund investments are appropriate given board investment policies.*

45. Review proprietary fund investment portfolios for any structured securities holdings. (Most structured securities are unsuitable for money market funds, such as inverse floaters, cost of funds index floaters, constant-maturity Treasury floaters, dual-index floaters, and range floaters.)

- **Check documentation for compliance with investment policy, results of sensitivity analysis (stress testing), evaluation of pricing, and liquidity and credit risk prior to purchase.**

46. Review current ratings from rating agencies such as Standard and Poors (S&P is a rating agency of many money market funds). Try to determine if the rating agency has any plans to change (especially downgrade) the current rating.

References

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(c)	Loans and Investments
§ 1464(q)	Tying Arrangements
§ 1468(a)	Affiliate Transactions
§ 1468a	Advertising
§ 1468b	Powers of Examiners

Federal Deposit Insurance Act

§ 1828(m)	Activities of Thrift Subsidiaries
§ 1831e	Activities of Savings Associations

Code of Federal Regulations (12 CFR)

FDIC Rules and Regulations

§ 303.13(f)	Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary
§ 303.13(g)	Notice by Federal Associations Conducting Grandfathered Activities

OTS Rules and Regulations

Subchapter C: Regulations for Federal Savings Associations

§ 545.74	Service Corporations
§ 545.74(c)(4)	Securities Brokerage Services
§ 545.77	Real Estate for Office and Related Facilities
§ 545.78	Leasing

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.4	Affiliate
§ 561.45	Definition of a Service Corporation
§ 561.46	Definition of a Service Corporation Affiliate
Part 563g	Securities Offerings
§ 563.33	Selection of Directors and Officers
§ 563.37	General; Operation of a Service Corporation Liability of Savings Associations for Debt of Service Corporations
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.42	Additional Standards Applicable to Transactions with Affiliates (Section 23B)
§ 563.76	Offers and Sales of Securities at an Office of a Savings Association
§ 563.132	Securities Issued Through Subsidiaries
§ 563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records
§ 563.171	Compensation
§ 571.7	Conflicts of Interest
§ 571.21	Separate Corporate Existence of a Service Corporation

Other Reference

Retail Investment Sales Guidelines for Banks, issued jointly by the six National bank trade associations (January 1994)

Office of Thrift Supervision Bulletins

TB 23a	Sales of Securities
TB 23-2	Interagency Statement on Retail Sales of Nondeposit Investment Products
TB 23-3	Joint Interpretations of the Interagency Statment on Retail Sales of Nondeposit Investment Products
TB 31-2	Application of Securities Offering Rule to Material for Offerings of Debt